Research @ Citi Podcast, Episode 45: U.S. Economy and the Fed — What's Next?

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Transcript:

Andrew Hollenhorst (0:00)

Remember, we do get another jobs report before the September FOMC meeting. If that jobs report were to come in weaker than I think consensus is expecting, if we got zero payrolls, if we got the unemployment rate just shooting higher to 4.4 or 4.5, then you could be in the world of thinking about a 50-basis point cut.

Rob Rowe (0:23)

Hi, everyone. I'm Robert Rowe, U.S. Regional Director of Research. Welcome to our Research @ Citi podcast. With us on the podcast today is Andrew Hollenhorst, our Chief U.S. Economist. Welcome, Andrew. And we figured that today we would have an update on both the U.S. economy, Fed doings, and everything thereof. How are you doing, Andrew?

Andrew Hollenhorst (0:43)

Yeah, thanks very much, Rob. Glad to be here. A lot to talk about.

Rob Rowe (0:46)

A lot to talk about. First, you know, maybe we can start off with some recent data. And frankly, I went on vacation for a week, and I feel like perhaps the narrative in the marketplace has changed both in terms of markets and in terms of the Fed, and perhaps in terms of rates as well. But first off, how should we look at these large downward revisions that we've seen to payrolls? And how has that potentially changed your view on the labor market?

Andrew Hollenhorst (1:09)

Yeah, you did miss a few things, Rob, and maybe the biggest one were those downward revisions to the payrolls number. These were huge downward revisions, 258,000 downward revision to the prior two months of payrolls report. So, we got the new number for July, but we also updated those numbers for May and June. And what the data show now is, whereas we thought before we were running close to 150,000 jobs per month, that number now is a lot closer to zero. We averaged 35,000 jobs per month over the last three months. And that job growth is really focused in the healthcare sector.

So if you look outside the healthcare sector, we're actually flat to down in terms of the number of jobs that we've added. So it just completely changes the conception of the labor market, where we now know that that pace of hiring was much slower. From our view at Citi, it didn't change our outlook as much as I think it changed the market outlook, because we had already had more concerns about the labor market. You didn't really see this in the headline numbers. You didn't see it in the unemployment rate. You didn't see it in those payrolls numbers. But you did see it in some of the details of the jobs reports and the other data that we have on the labor market.

One aspect of this labor market, which we've been highlighting, is that this is a low-hiring labor market. So, the unemployment rate is low. The way you can have a low unemployment rate, even with low hiring, is the layoff rate stays low. So, if you have a job, you're likely to keep that job. But if you become unemployed, it is a lot harder to get back into this labor market. And we're seeing that in a variety of statistics. In the JOLTS survey, we directly measure that hiring rate. But also, if you look at the unemployment data, the overall rate, 4.2%, that's low. But if you look at the rate for new college graduates, if you look at the rate for new entrants to the labor market, those unemployment rates are rising. And that's telling us that it's harder to get a job in this labor market than it has been historically.

Another thing that you can look at is just the claims that people file for unemployment benefits. Now, the initial claims are very low. That's telling us that the layoff rate, again, is staying low. But the continued claims, people coming and filing month after month, week after week for unemployment benefits, those are staying more elevated, which would tell you that more people are flowing through into the ranks of the unemployed.

So, I think there's going to be a lot more concern from Fed officials about downside risk to employment. The final thing I want to mention is that unemployment rate itself. 4.2%, like I was saying, that's close to Fed official measures, economists' consensus of where full employment would be. So that doesn't look too concerning on its own. It's been pretty steady for the last year. But when you start to look at the details, again, you kind of zoom in on what's driving that unemployment rate, it turns out over the last few months we've had a big decline in the participation rate. There are just less people in the labor market. That's part of the reason that unemployment rate is staying low. If it hadn't been for the participation rate falling, if it hadn't been for the labor market shrinking, essentially the supply of labor shrinking, the unemployment rate today would be at 4.8% or 4.9%. So that would look a lot more concerning.

Now, there's a big debate that's going on about, you know, is this weak hiring because of weak demand or is it because the supply of labor is just growing at a slower rate because immigration has slowed down? You know, we look at the data, we try to look at things like wage growth. Are we getting really strong wage growth? We aren't. So, to us, this does look like weak demand. We think that's going to show up in more soft labor-market data upcoming. But again, Rob, those revisions, you just can't call this labor market solid anymore.

Rob Rowe (5:02)

And two things on that, Andrew. One, I know JOLTS also looks at job openings, and I don't know, have those changed? Have they gone up or down? And also, if the participation rate is going down, is underemployment rising?

Andrew Hollenhorst (5:16)

So, in terms of the job-openings numbers there, we had seen job openings that have been falling. They've come back to kind of a historically normal level. And what I mean by that is, “Where are the openings compared to the number of unemployed individuals?” We have a little bit more than one job for each unemployed individual — that is pretty healthy for a labor market. So, it's not that the job openings are too low, but that is coming down from a much higher number. We had a very, very tight labor market a year ago, a couple of years ago, where you had almost two job openings for every unemployed individual. So that's really changed substantially.

A lot of that wage pressure is not there in the job market now because those job openings have come down. And in terms of underemployment, we do see that in a variety of different metrics. One of those is the number of so-called discouraged workers, people who have just left the labor force because they're not finding a job. That's a sign of weakness in the labor market. Other measures of people working part-time when they'd rather be working full-time, all of those things are showing us that this is a labor market that's loosening.

Rob Rowe (6:19)

That's very interesting. And what I'm curious about, Andrew, and I'm going to segue into inflation in a sec, but are we seeing the signs of that in consumption yet?

Andrew Hollenhorst (6:27)

So, you've seen a slowdown in consumer spending. I want to be clear about this: It's a slowdown from a really strong pace of consumer spending. So, we're running much, much stronger growth in spending than we typically do. As we've come into this year, you've really seen that slow down. It's a little bit complicated in the data because we had some front-loading related to tariff effects, but you smooth through all of this, whereas we were running 3% to 4% consumer spending last year, now it looks like we're running 1% to 2% consumer spending this year. So not a recession by any stretch of the imagination, but a really significant slowdown.

Rob Rowe (7:05)

And obviously, there's been a lot of discussion about how tariffs were going to affect inflation, how they were going to affect consumer prices. I think Core PCE inflation is still closer to 3% than 2%. Two things there: Is that an impediment to the Fed cutting rates? But also, are we seeing at all the effects of these tariffs on consumer prices around inflation?

Andrew Hollenhorst (7:28)

Let me start on the tariff question, and then I'll come back to inflation more broadly. On the tariffs, it seems very straightforward, right? You increase tariffs, that's going to increase the cost of goods that importers are paying. And then if that cost gets passed through, consumers will pay higher prices. But the big question, and I think this was always the question, is how much of that cost really does get passed through to consumers? We know that cost has to be paid somewhere. It could be paid by foreign producers. They could cut their prices. We have the import price index, that hasn't fallen. That's measured before tariffs are applied. So, because we're not seeing big declines there, it doesn't look like foreign firms are bearing the cost for the most part. But then you look at the consumer prices and we haven't had a big increase in goods prices. We haven't had big spikes in goods prices like we saw back in 2021 or 2022 when we were getting very high inflation related to COVID.

You've had some additional strength. Home furnishings is the one category where it looks like, yeah, maybe there's some tariff effect in there. But you're looking pretty hard at that point; to be honest with you, you just really don't have a smoking gun that these tariffs are pushing through into consumer prices. The question on that now is, “Are we going to see that with a lag?” Is it just that it's taking firms more time to pass those costs through? Or are firms just going to be able to absorb those costs in their profit margin? So the jury's still out on that a little bit, but I would say so far, we're really not seeing a big effect from tariffs and goods inflation. In our base case, we'll see some more of that as we go through the year.

Now, thinking more broadly about inflation, what the Fed should really be concerned about is not a one-time price-level effect on the price of goods. That's what you would expect with tariffs. What the Fed should be concerned about is, “Are you getting broad inflationary pressure?” Is this coming through to services prices? And to your point, Rob, we're not back to 2%. You still do have some residual inflation where you're running 2% plus instead of the kind of 2% minus that we ran pre-pandemic. So you'd like to see a little bit of more sustained slowing. I would say for the second quarter for PCE inflation, if you annualize it, it came in at 2.5%. That's not too far off from target. And especially if you think maybe there were some early tariff effects in there. Goods prices were a little bit stronger.

You've seen shelter inflation slow very significantly. Remember, we had these really rapid rises in house prices. Well, now house prices are flat to down. So we're really not worried about shelter inflation at this point. And services inflation, aside from shelter, that's going to depend on the labor market. If you don't have a lot of wage pressure, you're not going to see a lot of pressure in services prices. So, I am not too concerned about persistent higher inflation. I do think that's still an upside risk that Fed officials are going to be worried about. And it is the case that we're not fully back to 2%. If we were fully back to the 2% target, we could basically say, “Let's leave aside inflation and let's just talk about the labor market and where policy rates should be located relative to the labor market.” Unfortunately for the Fed, they have a harder task, which is, “How worried are they about the labor market versus how worried are they about inflation?” And that's going to determine interest-rate policy.

Rob Rowe (10:48)

And to be clear, your team's original estimate on what the fillip to inflation would have been for the tariffs was not that significant, right? Maybe a max of a half a percent, or was it higher or lower than that?

Andrew Hollenhorst (11:02)

Yeah, you can get numbers like one percentage point in terms of higher inflation. And thank you for noting that, Rob. We have always been more on the side of these tariff effects might be on the smaller side. Not that they're not going to be significant. Not that we're not going to see something. I think there were forecasts out there for inflation to get to 4% this year. We were never there. Again, thinking that not all of these tariff costs are going to be passed through to consumers.

Rob Rowe (11:31)

Right. And I think there's anecdotal evidence to some degree, like, for instance with Japanese automakers, that they may eat the tariffs in order to maintain their market share in the U.S.

Andrew Hollenhorst (11:41)

Really interesting case. That is one case where we have that number from the Japanese data, where we know that Japanese automakers basically fully absorbed that tariff. Like I was saying, we're not seeing that as clearly in our import price index data, but it doesn't mean that some of that's not going on. But then the question you still ask is, “Is that forever going to be absorbed by that foreign firm or did they start trying to push that cost through?” Does that end up being absorbed by a domestic U.S. firm? Does some of that push through to the consumer? And when you start thinking through it that way, well, these effects could really show up over many months. But to your point, Rob, if they are showing up over many months and they're not that large, we might just not see them that clearly in goods inflation at all.

Rob Rowe (12:23)

Yeah, that'd be interesting. And bringing this all together in terms of the Fed, obviously, there was a lot of scepticism that the Fed would necessarily cut rates a few months back. Now, as we progress through the summer, markets are pricing more of the potential for the Fed to cut soon. And I guess the question I have is, “Where are we on that?” What's our view on what the Fed will do? As you just alluded to, are they concerned more about labor markets or inflation at this juncture?

Where do you see them coming out? Do you see them cutting rates? And do you think this is the beginning of a long-term easing cycle?

Andrew Hollenhorst (12:56)

So, we have for some time been of the view that the Fed would be cutting further this year and that concerns about the labor market would ultimately drive those rate cuts, even if there's still some lingering concerns about upside risk to inflation. So basically, we think those labor-market concerns will dominate. I would say to your point, Rob, that was a little bit of a lonelier view a month ago or a couple months ago, because again, we hadn't had those revisions to the labor-market data. It wasn't as clear in the headline numbers for the labor market.

So, we thought we would see that come through clearly enough. To bring this back to those revisions that we had to the jobs report, the most important thing is not that fundamentally the outlook on the jobs market is so different now, at least from our perspective, but that you just can't ignore it. You can't avoid that fact because you just have that really weak hiring in the data.

I think what we're starting to see is Fed officials shift a little bit and get comfortable with this idea of cutting in September. Of course, it was very contentious at the July meeting. We had two governors that dissented from holding rates steady in July. That's very uncommon. We typically don't have any governors dissenting. Having two governors dissenting is really atypical. And I think that is a sign that we're at something of an inflection point here, something of a turning point. And the question was, "Which way were the data going to push?" Were we going to get data that made Fed officials more concerned about upside risk to inflation, or data that caused them to be more concerned about downside risk to employment?

St. Louis Fed President Musalem talking about this just yesterday and saying those risks, the upside to inflation, he's a little less concerned about for some of the reasons that we just talked about, Rob, and the downside risk to employment, well, that's obvious after the jobs report. You should be more concerned about the downside risk to employment. So, I think that's where Fed officials are kind of moving. You obviously have a big split in the committee. But remember that the median dot, the median Fed official thought back in June that they would be cutting rates this year. And in June, we already knew that the tariffs were coming, and Fed officials had put some estimate for inflation effects of those tariffs into their forecast. So, I think we're now on a pretty clear path for them to be cutting in September with this new labor-market data in hand.

It's not that they're going to say "all clear" on inflation, but the other thing to keep in mind is the consensus across Fed officials is that policy rates are still restrictive. They have different ideas about how restrictive they are, and by that, I mean they're still at a level that would slow the economy, bring inflation down. The risks are unbalanced, and if the concern is about upside risk to inflation, then yeah, you should keep rates at restrictive levels because you're not that concerned about the labor market. It's a lot harder to say they're unbalanced now. And I think that's what we were hearing from Musalem, that these risks are coming into better balance. Now, they're not necessarily coming into balance the good way, right? The good way is that you would have not a lot of upside risk to inflation, not a lot of downside risk to employment. They're kind of coming into balance the bad way in the sense that you still have that upside risk to inflation. You just now have more downside risk to employment. That would argue for a neutral policy-rate setting. Chair Powell said that at the last FOMC meeting.

So, I think that's going to be the argument. And I think we could hear more about that at the Jackson Hole symposium, that with these risks coming into balance, it makes sense to move towards neutral. Where is that neutral? Some Fed officials are going to say closer to 3%. Some are going to say closer to 3.5% or maybe even the high threes. But most if not all of them are going to say lower from here. So, it's a pretty easy case to be made, I think, to cut at least 50, 75 basis points from here. Further cuts are going to depend on what happens with the labor market. Do we see further weakness in the labor market? Are Fed officials feeling they need to move faster? Remember, we do get another jobs report before the September FOMC meeting. If that jobs report were to come in weaker than I think consensus is expecting, if we got zero payrolls, if we got the unemployment rate just shooting higher at a 4.4 or 4.5, then you could be in the world of thinking about a 50-basis point cut.

So, I think we should have that possibility out there. 25 looks very likely, 50 not the base case, but they could cut 50 if they saw a weak jobs report. You kind of think about last year when they cut 50 basis points in September, and that was partly because the jobs data subsequently made them think, well, if they had had that jobs data in hand, they would have actually cut at the July FOMC meeting. So, they were catching up a little bit. That's a possibility this year again.

Rob Rowe (17:43)

Let me ask a question kind of in reverse on inflation. Is it possible that if the Fed started to cut rates, that they could actually incentivize inflation themselves? Because perhaps in this environment, we might see inflation go a little lower than 2.7%. But I saw a headline in the [Wall Street] Journal today that mortgage rates have come down to a point where it may incentivize home ownership again. If that happened, it could drive home prices higher, which would be a significant input to inflation. If the Fed were to cut rates further from here, would it incentivize a hot housing market, for instance?

I ask because there's elements of the U.S. economy that seem to be running hot, especially in tech and innovation. When you think about capex there, the growth in data centers etc., I don't know that that necessarily spurs additional jobs. But how do we rectify those things? Do we think growth in the U.S. is actually going to slow down at this juncture? Or are there other elements of the economy that are moving really fast? And any incentive, such as dropping rates here, could actually boost not just economic growth, but potential inflation behind it?

Andrew Hollenhorst (18:54)

This is always the trade-off for monetary policy. You cut rates, that protects employment, that drives growth, but maybe that also drives inflation higher. So that is the trade-off that they face. I think you're thinking about it the right way, Rob, or that's how I would think about it. Is this an economy that is going to end up running above potential growth and labor markets getting very tight and house prices that are zooming higher if you start cutting interest rates? And I just don't think that's where we are in the cycle right now.

The housing sector is probably the best example of that. House prices are actually flat to down. We have housing starts that are moving lower. So yes, cutting interest rates is going to bring mortgage rates down. That's going to stimulate the housing sector. But it is very hard in the current environment where you have the housing sector in contraction to think that that would be a bad thing or an inappropriate thing.

Now, to your point, Rob, if you look at investment overall, investments held up better than you might have expected with high interest rates because of this tailwind from AI and tech investment. That could continue. I don't think that that's that rate-sensitive. I really think it's other kind of non-cyclical factors that are driving that. So, I'm not sure that monetary policy is going to have a big effect on that. But that's the problem with monetary policy. It's a blunt tool, right? For the housing sector, it makes all the sense in the world to have lower rates. For other sectors, it's not as clear. But I would say broadly speaking, yes, this is an economy that's slowing. It looks like growth slowed to below potential in the first half, which means you're not creating inflationary pressure. So I don't think you have a big risk of cutting rates here.

Rob Rowe (20:36)

Fantastic. Thank you very much, Andrew, for all your insights and joining us on the podcast today.

Andrew Hollenhorst (20:41)

Yeah, my pleasure. Thank you, Rob.

Rob Rowe (20:44)

This episode of Research @ Citi was recorded on Friday, August 15, 2025. I'm your host, Rob Rowe. Join us next time when Heath Terry joins Lucy Baldwin to discuss tech and innovation.

Disclaimer (20:58)